THE SIXTH SENSE

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FOREWORD

CREDIT in the abstract has been so thoroughly expounded by able authorities that in the six articles which follow, our efforts have been devoted largely to credit in the concrete, and it is hoped that the reader may find herein something of practical value.

It will be noted that these articles deal in the main with bank credits. To properly apply to commercial credit they should be modified and changed to suit the more liberal conditions obtaining in mercantile risks. The principles themselves do not change, for the principles governing all credit risks are the same.

THE SIXTH SENSE

ARTICLE I

TRADE CONDITIONS

CREDIT is the correlative of capital. It liquefies capital and is, in turn, dependent upon capital for its redemption. The granting OF credit increases the demand FOR credit. This is true all along the line from manufacturer to distributor. The Government, in issuing a silver certificate, is the recipient of credit for the difference between the face of the note and the value of the collateral.

Banks are the great reservoirs of credit. One of the chief functions of the banks is the manufacture and distribution of credit. Some one has said that success in banking depends upon the timely use of the word "No." Banks are clearing houses for the transactions of commerce and finance.

A Cotton dealer in Georgia makes a sale to a manufacturer in New England. He receives a check in payment on a Boston bank. He deposits the check in his bank and re-

ceives CREDIT for it; his bank sends the check to its New York correspondent and receives CREDIT for it; the New York bank sends it to its Boston correspondent and receives CREDIT for it; the Boston bank checks it against some debit through the Clearing House, and in this way receives CREDIT for it. So that before the check reaches its final destination it has created four credit and four debit transactions, and perhaps, in none of these transactions, has any cash whatever changed hands. But all these credits involve practically no element of risk. The intangible "Credit Risk" in the generally accepted meaning of the term is absent. These articles will not deal with credit transactions of this nature. The illustration serves to show, however, the distinction between the two kinds of credits—those that involve a risk, and those that do not.

Every credit transaction is supposed to be based on a cash equivalent. The only security that is absolutely liquid is cash itself, and for that reason money based on the unchanging standard of gold is the measure of value of all wealth. In the United States the total amount of wealth is estimated at one hundred and eighty billions of dollars;

the total amount of money less than four billions of dollars, so that only a trifle more than 2 per cent. is used as a medium in exchanging one form of wealth for another form. It is the wonderful mobility of credit and the efficiency of the financial system that makes the handling of these multitudinous transactions possible.

There is, however, one great danger existing in our complex system of finance and economy. That danger is the over-extension of credit. The only safeguard is conservatism, and no agency can apply the brakes of conservatism more effectively than the banks. Over-extension is the pyramiding of credits until the credit structure becomes too heavy for its cash foundation. The inevitable collapse ensues, and a long period of financial retrenchment and repairs follows.

What, therefore, appears to be the most important demand upon any bank or business concern, is to keep its affairs in such shape that the cash standard of value as measured against its assets, will always find ample evidence of its ability to convert those assets into enough cash to pay its debts.

A manufacturer experiences a period of

good times. He enlarges his plant, taking his surplus and converting it into assets of a fixed or slow character. A period of dull times comes on; his liquid capital has all been consumed, and his bank asks him to pay down his loan, which he is unable to do. Therefore, neither the bank, nor the manufacturer can "Cash in." This is an illustration of over-extension.

We have only one way to judge the future, and that is by the past. The pendulum swings both ways. This rule is especially applicable to industrial activity. An industrial fact of today may have seemed improbable two years ago. We must follow the current of economic conditions. All business is more or less interdependent, and a basis for the calculations of every credit grantor should be a reasonably accurate knowledge of business conditions and prospects.

A fair risk, under normal conditions, may be a poor risk under unfavorable conditions. The fault may not lie with the subject of the risk at all. It may be due to causes beyond his control, such as a depressed state of trade. Hence the importance of anticipating these

conditions, and applying the knowledge before the risk is in the hopeless class.

Science in credit granting, however, is not in the ability to play safe. That is a narrow interpretation. It is a rule, which, if lived up to, means lack of progress. It means safety at the sacrifice of profit. Such credit granting is a retarding rather than a helpful influence in the progress of any bank or business concern. As it is a poor rule that does not work both ways, so the ability to conserve resources in anticipation of adverse conditions presupposes the ability to know when to use those resources in anticipation of an era of good times. Just as a fair credit risk in good times may be a poor credit risk in bad times, so may a poor risk in bad times be a fair or good risk in good times.

As a working basis, therefore, in credit granting or in fact in any business plans, especially in plans for industrial expansion, an adequate knowledge of the trend of business conditions is important. This can be obtained only by a broad survey of the industrial and financial field. Keep not only abreast, but ahead of the times. Certain underlying principles are always at work. Are they making for prosperity or adversity?

Before the panic of 1907 money rates on both call loans and commercial paper were abnormally high. The failure of the Knickerbocker Trust Company of New York was an economic Vesuvius. Disrupting financial forces had been smoldering and growing in intensity. When they found a vent in that failure a financial cataclysm was the result. Fortunately the banks pulled together through their Clearing House Associations, and the crisis was tided over. We may never have another such panic. The lesson was learned, and the Federal Reserve Act enacted to safeguard the country against a recurrence of such a disaster.

In the field of industry, however, so long as we have human nature, depression will follow periods of expansion, and expansion will follow periods of depression. To be forewarned is to be forearmed, and to keep well posted on general and special trade conditions is an important factor in the securing of the greatest measure of success in the dispensation of credit.

ARTICLE II

INVESTIGATION

HAVING established a sufficient knowledge of trade conditions, we are ready for the next, and possibly the most important factor in credit work, viz.: Investigation. As the justice of a court verdict depends upon an adequate knowledge of the facts in a case, so does the quality of a credit opinion depend upon the intelligence and care with which the investigation of the risk is conducted, and the credit information collated.

Investigation, then, lays the foundation upon which the opinion of the individual credit risk is built. A thorough investigation is essential to the proper analysis of a risk. In this branch of the work the ability of a Sherlock Holmes would doubtless be highly desirable. Genius, however, is largely a capacity for hard work, and persistent and careful effort in the securing of credit information is bound to be rewarded in the mini-

mizing of losses just as a careless gathering of data will have an opposite result.

In the history of nearly all banks and business concerns are many instances in which the careful gathering of information has been responsible for the avoidance of losses, and the same records, perhaps, contain cases in which had a little more thoroughness in the first investigation been observed unfortunate results would have been averted.

Let it not be forgotten that favorable information is always the easier to obtain. The subject of a doubtful risk will naturally strive to keep reasons for doubt from the minds of creditors, so that the things he does which he should not do are made to appear as right and proper, while the right and proper things take care of themselves. In many of such cases these bad symptoms are only revealed by a persistent and intelligent investigation. Recommendations of friends may be unduly influenced by friendship. References would hardly be submitted unless it were certain their use would bring favorable reports. They merely confirm something which in the giving is already practically assured. The line of investigation should be pursued further. A competitor, for instance, may sug-

gest something which would uncover the most vital point of weakness—something altogether unsuspected. It must be a reasonable assumption, of course, that the competitor is without bias. The point here made is that ordinarily an investigation should not stop with those sources of information which would naturally be favorably disposed to the subject of the risk. Unless already closely familiar with the status of the case, an entirely non-committal attitude should be assumed until the field of investigation is covered from different angles.

A manufacturer of hosiery applies for a substantial line of bank credit. The applicant is practically unknown to the bank, having moved from a former location, and desiring to change the bank account as a matter of convenience. The concern, which is incorporated, is owned by two men. As references the former bank is given also several houses in the trade. A financial statement is also submitted. The line of procedure in the investigation of this case would be about as follows:

A. Inspection of the company's plant.
B. Regular agency reports.
C. Special agency report, if available.

D. Trade and bank references.

E. Other trade sources.

F. Competitive sources, judiciously selected.

G. Other sources of investigation, suggested during the course of the investigation.

Note.—In the case of a bank credit, as distinguished from a mercantile credit, the company being a corporation, the note should probably be endorsed by the two principals. In this event the investigation should include close inquiries about their personal resources outside of the business. This point, of course, should also be covered with the principals themselves at the time application for credit is made.

Rule "G" is a very important one. Among other things which the investigator should always keep in mind as he pursues his inquiries is the idea of seeking other channels of information. At the same time close scrutiny should be kept upon reports received for suggestions along the same line. The central thought is thoroughness, and the object close information.

No investigator is properly equipped for the work, however, without appreciating the importance of having sufficient information

on certain fundamental points in every risk. These points are:

1. Moral character and habits.
2. Management (quality and character of).
3. Business and financial capacity.
4. Practical experience.
5. Contingent liability (this may and should be shown in financial statement).
6. Capital investment (adequacy of).
7. Business and personal record.

While in the case of the hosiery concern cited, the method of investigation applies to a bank credit, it can just as readily apply to a mercantile credit with proper modifications. An average mercantile risk will not carry so large a line of credit as a bank risk, while the returns on a merchandise transaction will be many times larger than the profit on a banking credit. It is, therefore, only reasonable to expect in the case of a bank credit risk more direct information from the applicant for credit. Seldom is a financial statement asked for or expected direct from a customer in a mercantile risk, but, on the other hand, this information is often supplied by the mercantile agencies.

Should a bank make a loan of $5,000 at 6 per cent. for three months, the net return to the bank would be $75. Should the same amount be involved in a mercantile risk for goods sold at a profit of 15 per cent. the return to the seller would be $750, or ten times the return on the bank transaction. There's a difference, and this difference accounts for a bank being more particular in extending credit than a business concern.

Investigation must not stop with the results of the first collection of credit data. It is never really finished. Periodical revisions of the credit files is a rule in every properly conducted credit department. But more than this, a careful watch should be kept on little things. Straws show which way the wind blows. Little scraps of information time and again are more important than large facts which continually stare one in the face. Investigators should be posted on credit accounts, the names of the personnel, and their affiliations, as well as the affiliations of the concerns they represent. An instance in this connection comes readily to mind.

A certain large manufacturing concern never had their credit questioned. The moral hazard had always been of the highest,

the capital apparently amply sufficient, as shown by the concern's financial exhibit. It was a credit risk which stood among the highest. In going through some reports of a miscellaneous nature, it was noticed in the report on a second grade promotion scheme, that one of the officers was the president of the subject company. The matter was taken up and it was decided to go slow in any further credit dealings with the concern. A short time afterward the company became financially involved. The singular thing about the case was that the company's own bank did not know the head of the concern was lending his name and financial assistance to an enterprise of a doubtful nature. It was a stray bit of information, which, properly applied, was of first importance in its bearing on the credit of the concern.

The attitude which should be assumed toward an applicant for credit has been a cause for some difference of opinion. It seems unfair that any one applying for credit be held guilty until proved innocent, or in the credit vernacular, that a risk should be regarded as a poor one until proved a good one. Rather the mental attitude should be entirely

free from bias—coldly critical, if you will, but eminently just.

It is important to remember, however, that diplomacy and tact are co-requisites in the investigation of credit risks. Care should be exercised to so pursue inquiries that no unnecessary stirring up of adverse gossip will be the result. Be judicious in selecting sources of information, and, above all, never fail to show a disposition to cordially reciprocate.

Finally, in either type of credit risk, bank or mercantile, in bank credit especially, and in mercantile risks involving large amounts, time given to close and careful investigation is a matter of the first importance.

ARTICLE III

THE FINANCIAL STATEMENT

THE old saying, "Figures don't lie," should, when applied to financial exhibits, at least, be qualified to read, "Honest figures don't lie."

The false statement has always been the chief bugaboo of credit men. What safeguards are there against undue inflation and misrepresentation in the financial statement?

A concern may be honest in the ordinary acceptance of the term, and yet make a statement which, while not actually fraudulent, may be misleading enough to secure for that concern an unwarranted line of credit.

Assets, as valued on statements, might shrink materially in liquidation, but this would not indicate a deliberate attempt at falsification. Estimates of assets are often based on their value to the business as a going concern. Machinery, even with a reasonable amount charged to depreciation,

would naturally still further depreciate if thrown on the market. Yet that is no reason why a concern should carry its machinery account without some consideration of its worth to the business, instead of its value under forced liquidation.

No fixed rule can be applied to cover the proper proportion of quick assets to debt. It is true, a bank in buying commercial paper generally requires quick assets to be at least twice the amount of quick liabilities. This is probably a good rule for a bank to observe in making such outside investments, but in ordinary credit giving, either banking or mercantile, to adhere to such a rigid rule would be altogether impracticable and inadvisable.

A manufacturing concern with its plant and machinery efficient and up to date might be a very good risk, even though there was a small margin of quick assets over quick liabilities. No one rule will apply to all financial exhibits, and every risk should be decided on its own individual merits.

So with the merchandise item. In certain lines of business this item may seem out of proportion to the amount of accounts receivable, and yet be in strictly proper ratio to the

outstandings. In the wholesale grocery business, for instance, accounts and merchandise should, ordinarily, be about the same in amount, whereas in the statement of a knit goods manufacturer selling direct to the trade, the figures, if compiled at the end of the calendar year, may show a large stock of merchandise on hand ready for spring delivery when accounts receivable are at the low ebb.

Wherever possible the volume of business should be known in order that it may reasonably be determined whether the figures are in fair proportion. In the ordinary line of business, if the annual volume is say $200,000 and the outstandings are 33 per cent. of this amount at a time when accounts receivable should be about normal, the indications would be that the trade sold was of an undesirable class or that the figures were inflated, or both. In this phase of the analysis, however, certain other determining factors should be kept in mind, such as the time of the year that the statement was made, the particular conditions obtaining in the line of business and the selling arrangements of the concern under consideration.

In a certain instance a concern became af-

fected with what is commonly known as a state of "dry rot." Physically there was every evidence of this condition, while year after year the business made no headway. Yet each annual statement showed an abundantly solvent condition. In every statement, however, the amount of the yearly sales was not given. Finally, one of the partners died and the business was liquidated. When the books were gone over it was found that the accounts receivable had been grossly exaggerated on the statement. Had the volume of business been known (and this information should have been politely insisted upon) it would have been readily seen that the accounts receivable were out of all proportion, which would have called for an immediate investigation. So that when statements are not properly audited, this is one of the important points to remember.

Just as assets may be inflated, so may liabilities be misrepresented also. Sometimes this condition may be detected by certain inconsistencies which are made apparent by bringing to bear in the analysis of the statement other information. An instance is recalled in which a concern made a good state-

ment; the figures were apparently in proper proportion to the volume and the capital sufficient to insure promptness in meeting trade bills. Yet this concern was in the habit of allowing its trade bills to become overdue and its trade reputation suffered accordingly. The concern failed, and while the business was being liquidated statements kept coming in from the trade for bills which had not been entered on the ledger. A good statement should mean a good trade record; otherwise a condition exists which calls for investigation.

The audit of reputable accountants is desirable. Such accountants will not countenance flagrant misrepresentations of value, and they will not indorse any estimates or methods which are not in accordance with a fair standard of ethics. Care, therefore, should be observed about statements audited by obscure accountants who might be tempted to overlook breaches of honesty, or might do so through ignorance.

Statements should be received, if possible, by mail, and the envelope attached to the statement; thus there is evidence that the statement was sent, and in proceedings against the maker this evidence might be of importance.

It is not so much a matter of using any particular form of statement blank. There are many standard forms of statements, and it is more important to secure answers to the important questions, which practically all these forms contain.

Here again a sense of the fitness of things should be observed. Competition for business will hardly justify any bank or business concern in assuming an arbitrary attitude toward all credit risks. Wherever possible it is, of course, advisable to have information on the statement submitted complete. Again a good concern may submit a statement on its own stationery. Would it be good business to insist upon a statement on a special form in this instance? Tact and common sense must decide the issue in each case.

The practice of having books audited by a certified public accountant is rapidly growing in favor, especially among the better class of business concerns. Such a practice helps immensely in the attitude assumed towards the risk, for it indicates a disposition on the part of the borrower or purchaser to be fair and frank with the creditor as well as with himself.

If the statement is a favorable one, and

every other phase of the risk checks up in harmony with that showing, it would then probably be in order to accept it with reasonable confidence, subject, of course, to allowances for depreciation.

In addition to the regular questions covering the various items of assets and liabilities, a statement form should also call for certain special information. We might list these special items in order, as follows:

Amounts due by officers, stockholders or sales agents.

Amounts due by subsidiary or controlled companies. (In the case of a firm this item should read "amounts due by members of firm.")

Amount of assets pledged as collateral.

In the liability column the amount of liabilities secured by collateral, judgment note, or otherwise, should be specified.

Other information should also be obtained on the following points:

Amount of contingent liability, either by accommodation indorsement, bills receivable outstanding, or any form of guarantee.

Annual volume of sales.

Losses by bad debts.

Total amount of expenses.

Net profit.

Annual dividends, or amount withdrawn by partners.

Amount charged off for depreciation to plant and machinery.

Are all bad or doubtful assets excluded from statement?

Amount of fire insurance.

Bank accounts.

Are books audited; if so, by whom, and on what date?

Just what form of statement blank would be most desirable to use is, as stated, not such an important matter. The American Bankers' Association has a form which is comprehensive and complete. The Federal Reserve Act calls for certain information on statement forms from concerns whose notes are sent to the Reserve Bank for rediscount by member banks. It was the apparent intent of the framers of the Federal Reserve Act to standardize credit. This article will not attempt to prove if such a plan is practicable.

When a uniform fraudulent statement law is enacted in the various states; when the creditor is fairly protected against fraud by statutes which will not permit a debtor to

escape through quibble or technicality a sentence of just punishment for obtaining credit under false pretense; when the spirit as well as the letter of the law is interpreted to uphold the rights of creditors; then false statements will be largely a thing of the past. Then the credit man may be more liberal in his attitude toward financial exhibits than he can now afford to assume.

Finally, in forming an estimate of any risk, based on the financial exhibit, it is of primary importance to keep in mind, not only the quality of the risk based on the enterprise as a going concern, but the probable situation from a creditor's standpoint, should the business at any time be wound up or liquidated.

ARTICLE IV

ANALYSIS AND DEDUCTION

MANY thousands of different words are produced from the twenty-six letters of the alphabet. So with the few principles governing analysis and deduction. In the study of credits, these principles are applicable to an almost endless number of different situations. In accountancy the simple principles of debit and credit do not vary; it is in the application of those principles to the varying conditions met with that makes modern accountancy a science. That two and two make four admits of no dispute. it is irrefutable logic. The difficulty is in properly applying that logic in the analysis of propositions each one differing from the other in its make up.

Credits, however, can never become an exact science, like accountancy for instance, because they are based on conditions subject to change. Conclusions are not always borne

out by results. At best, the principles used can be worked out in a system which, if followed, should help to minimize losses, but which cannot, for obvious reasons, provide against the unexpected or unknown. But chances of loss can be reduced and possibilities of profits thereby increased without any claims on infallibility.

Every risk has three important divisions. Listed in the order of their importance they are:

Moral Hazard.

Ability.

Capital.

In the analysis of all risks, the first and most important thing to determine is the moral hazard. Any pronounced weakness disclosed in this respect is in itself sufficient to condemn the risk. But investigation of the moral risk should cover sufficient ground. Suppose a concern is dependent for its success upon a manager who has no interest in the business outside of his salary as an officer and manager, the other officers and the stockholders having no practical knowledge of the business themselves. The manager should be carefully checked up. An instance comes to mind in which a concern of this kind was

wrecked through the reckless and questionable methods of the manager. Here was an angle to the risk which ordinarily is overlooked, yet it should not be, because a creditor is interested, first of all, in that on which the success of the business largely depends. The manager was tricky and played upon the ignorance of the stockholders. Close investigation of the man's record showed he was tricky, and this knowledge was a warning to either cut the risk out or keep it under close scrutiny.

No matter whether the moral risk is poor in either a business or a personal way, the application of the rule should admit of no distinction, for the principle which mars a man personally may be reflected in his business also. Danger should be flirted with in the one case no more than in the other. If the risk is money good, be careful in extending credit if the moral risk is not good also. Under such conditions, a bank should extend no credit whatever.

In passing judgment upon the moral hazard, too fine a distinction should not be drawn. If a man takes a glass of wine, he is not necessarily a drunkard. There is a difference between temperance and intemper-

ance. If a man is a sharp and contentious trader, it is not necessarily a reflection on his moral character.

Ability in a credit sense is the ability to make good in the particular line of business engaged in. Natural shrewdness is a better asset than culture. How to add to the profit and loss account is of more importance than proficiency in the arts and sciences. Practicality is the basis of success in business. A man's ability is judged by his success, not his success by his ability. His record and reputation are his references. Consult them. Personality is an index to character, for while a clever man can act in dull fashion, a dull man cannot act cleverly, and no clever man is going to appear dull except for a clever purpose. A manufacturer may not know how to keep a set of books; on the other hand a good bookkeeper may know nothing of manufacturing. Everything else being equal, which would you consider the better business risk—bookkeeper or manufacturer?

One of the richest concerns in Philadelphia—a firm worth several millions of dollars, whose paper commands the lowest market rates—told the writer that, while they were on the high road to prosperity,

their bookkeeping was all done in one book, with one column for receipts and one column for disbursements.

So ability, to the credit man, means that form of ability capable of producing results in dollars and cents. A college education is desirable, of course, especially under modern conditions, but natural shrewdness and an education in the school of practical experience is the twin form of capacity that has produced the greatest results in the industrial world.

As to adequacy of capital, when the amount of the capital available is known, this is a question that is comparatively easy to answer. Capital requirements are heavier in some lines than in others. This is too obvious to warrant discussion, but it only emphasizes what has already been contended in another article that a credit man, especially a bank credit man, should have a wide general knowledge of the different lines of business.

Having determined that the information at hand is sufficiently definite and reliable, with a knowledge of the general requirements in the particular line as a basis on which to frame an opinion, the conclusion as to capital should be readily arrived at.

It should be borne in mind, however, that

a concern may have a large capital, but the actual working capital may be seriously deficient. So we speak of capital with special reference to the quick assets available for operating the business, reinforced, of course, by the capital invested in a fixed form.

The three most important factors in credit may be subdivided for checking purposes, as follows:

MORAL HAZARD

Personnel	Personal Impressions
Management	Reputation
Record	

ABILITY

Principals	Reputation
Management	Personal Impressions
Record	

CAPITAL

General Reports	Financial Statement
	Inspection of Plant

Here are two examples of analysis:	No. 1	No. 2
1. Nature of business..	Staple	Hazardous
2. Particular and general trade conditions.	Fair	Fair
3. Age of company ...	Five years	Two years
4. Management and profits	Fair	Reorganization
5. Moral hazard	Personal criticism	Good
6. Plant	Good	Fair
7. Record of principals.	Tricky	Unsuccessful
8. Trade standing	Good	Good
9. Statement analysis ..	No statement	Satisfactory
10. Capital	Reputed adequate	Adequate
11. Ability	Good	Fair
Any signs of overextension, speculation, personal extravagance, etc.	Personal Extravagance	No

Risk No. 1 is not acceptable because the moral risk is unsatisfactory.

Risk No. 2—should go slow and watch closely—business is not staple and the company's record is not successful.

In any article it is impossible to establish rules to cover all cases; each case has its own individual characteristics.

Suppose, for example, we have under analysis a concern manufacturing cigars. A credit man properly informed about this line of business knows that in order to push sales cigars are sometimes consigned to the stores. If such a practice is followed and the concern is not successful, what becomes of the accounts receivable? This method may also be used in other lines which are dependent more or less on advertising. So that investigation and analysis must have their own adaptation to the case in hand.

A life insurance company cannot eliminate mortality, but it can keep down the average of mortality by a fixed adherence to certain health requirements on the part of the applicant for insurance, and one of the most important functions of a credit department is to make applicants for credit measure up to a certain standard of credit requirements.

Again, an equally important qualification is in knowing when to get out by detecting

signs of weakness in a risk. A risk may be assumed and a credit extended on very good grounds, and a year afterward that risk may show signs which foretell trouble. Just as an apparently well man of today may have within him the seeds of disease which a year from now may bring him to disability and ultimate death.

Personal impressions are invaluable. A once prosperous concern which had been borrowing only in moderate amounts was visited and the plant inspected. Stagnation was stamped on everything and one could almost see signs of mildew and moss. The stock which at best had an uncertain value was old and grossly overvalued. The concern afterward failed and the failure merely confirmed all the symptoms which the personal visit disclosed. Back of the stagnation and dry rot there was a cause. The principal was an intemperate man; so the cause was inebriety, the effect mismanagement and the symptom general stagnation. But a different cause could produce the same effect; so while the cause is not always discernible, the symptoms often are, at least to the trained observer.

Personal extravagance is another fruitful

source of trouble. The symptoms would probably be different; but symptoms in this case would be harder to detect. Lack of progress might indicate it; but lack of progress might be a symptom of many other conditions also. Trading on other people's money is a common enough matter, and it is too much condoned by the banks. Many a concern would not be a steady borrower were the withdrawals of the principals in proper proportion to the earning capacity of the business. Certainly a bank has the right to criticize any concern in which it is practically a silent partner when the principals in that concern withdraw extravagant sums for personal uses. The bank not only has the right, but should make it a duty, to see that the practice is corrected. Yet many concerns resent any such attitude on the part of the bank.

Poor moral risk, incapacity, lack of capital, extravagance, mismanagement, overextension—all these bad elements, if they exist, may be exposed by careful investigation, analysis and deduction. They are the red flags of credit weakness and when once detected it is time to put on the brakes and keep a close lookout for trouble ahead.

ARTICLE V

REVISION AND RECORDS

WATCHFUL action" would be a good motto for every credit department.

Revision is reinvestigation. It is investigation to which is added the information gathered from actual experience with a risk. It, therefore, has a double value.

Outside revision, as a usual thing, may be periodical. Inside revision should be continual.

Revision and records, therefore, go hand in hand.

In bank credit, the steady borrower is the bete noire of all risks, but to eliminate all steady borrowing accounts would probably entail a needless sacrifice of good business.

The periodical liquidation of all loans is very pretty in theory, but it is poor practice. Suppose a manufacturer with a fine plant, unencumbered, is a steady borrower. He may prefer to use his bank rather than mort-

gage his plant. Is not his credit reinforced by his equity in the plant? That equity, indeed, may render his obligations a first class risk.

We recall a case in which a manufacturing concern was criticized for being a steady borrower. The concern finally decided to create an issue of mortgage bonds. When this was done all bank loans were paid off entirely. Was not this risk a first class one before the mortgage was placed?

The nature of the business also has an important bearing on a risk of this kind. Take a business in which purchases are paid for largely on cash terms. The concern may be a very heavy and steady borrower, but if the merchandise assets are unusually liquid, the risk may nevertheless be a first class one. Still another illustration may be found in the case of a concern whose product must go through an unusually long process of manufacture. In all such cases consideration should be given also to the worth of the business as a going concern.

In the records of a credit department attention to clerical detail may be overdone. When detail becomes a fetish, larger, more important things may be lost sight of. A

maze of unnecessary detail sometimes serves to obscure things of import. On the other hand, an insignificant detail may be so magnified as to unduly prejudice one's judgment of a risk.

Practical management will not countenance a theoretical hobby for red tape. We have in mind a manufacturer who had such a craze for system and office detail that the manufacturing and selling departments failed to maintain their required standard of efficiency. One of the plants he managed was sold out. The success of the other plant was only mediocre, and he disposed of his interests in that plant also. Yet this man is today recognized as a brilliant man theoretically and as such has a national reputation in manufacturing lines, but his penchant for system and red tape never helped his reputation as an unsuccessful manufacturer and distributer. A large bank which has been out of existence some years maintained an elaborate system for credit data. Minuteness of detail seemed to be a mania in their credit department. One of the principal causes for the bank's lack of progress was bad loans.

Thoroughness of investigation and revi-

sion is one thing, needless detail in keeping records is another.

Little things sometimes loom large as sidelights on a risk. In a bank risk for instance overdrawing an account may seem a small thing, but it is not unless satisfactorily explained.

Regarding forms for comparative records of financial statements, it seems unnecessary to keep a record of every separate item when we are really only concerned with certain classes or divisions comprising the assets and liabilities. There are so many conflicting conditions in every business and in the operations of any particular business that to analyze each little item on every statement submitted recording all these on a form and reconciling apparent discrepancies would seem not only impracticable but a waste of time. For quick reference for the use of officer or credit manager the following suggestions are made as to the items these comparative forms should contain. For continual reference we think that in the order given such a form contains practically all the meat of the credit data for the purpose of refreshing the mind on the risk and indeed passing judgment. Amounts of each item should be stated in approximate figures—say in thou-

sands and hundreds. Suggestions are made for a corporation form, but the form for a firm can easily be changed to meet the requirements of a co-partnership. Of course, as many columns can be used as may be desired.

Active assets.
Active liabilities.
Surplus active assets.
Other assets (excluding good will).
Total.
Less bonds or mortgage.
Net assets.
Less depreciation or reserve.
Net worth.
Capital.
Surplus.
Audited by.
Annual sales.
Proportion of receivables to sales.
Losses by bad debts.
Dividends.
Contingent liability.
Dun's rating.
Bradstreet's rating.
Indorser.
Indorser's responsibility.
Other bank accounts.

Line agreed on.

Remarks.

The reverse side of form should contain the same number of columns for the years in which should be kept the average balance by month, and above the average monthly balance say, in red ink, the line of credit outstanding for that month.

For cabinet files in which to hold the credit data the ordinary folder, indexed alphabetically, and numbered consecutively, is satisfactory. However, these are minor matters which can be arranged to suit the individual idea; any of the larger index companies can furnish the equipment and give the necessary information as to which is the better system.

In revising credit files the best plan, we think, is to systematically go over the risks gradually with the comparative statement form records and the information they contain as a basis for revision. These forms can be kept in a book folder, alphabetically arranged, and can be kept posted by clerks with the information furnished by the other departments in the bank. When an account is revised and brought up to date it would be well to make a memo of the date on the

form, so that continual reference to the file for that purpose will be unnecessary. In order that financial statements may be kept up to date, it would be well perhaps to run over these forms at least once each month, and if the statement is due write for it, if advisable, keeping a separate memorandum of such requests. By these methods, which are simple enough in themeslves, files and records can be kept fresh.

Extent of the revision will have to be determined by the information at hand as well as the status of the account.

For ascertaining at a glance the status and record of the account and the financial standing of the risk and such other important facts as may be noted thereon, the forms suggested are invaluable.

In revision there can be noted especially the tendency or drift of an account. The piecing of facts together may form a strong web of evidence. One may be distrustful of a concern without sufficient evidence. So-called intuition may be carried to extremes. A bank's criticism should, if possible, be a constructive one. Very often a bank can rehabilitate the business of a customer, thereby doing something of mutual profit.

A certain concern, in its annual statement, showed an increasing debt and no headway for several years. Bank balances were fair, but loans were steady. The concern did a good volume of business. Analysis of the situation by the bank led to one of two conclusions: the concern was either costing its goods wrong or else expenses were too high. This viewpoint was submitted to the head of the company and instead of resenting the suggestions of the bank they were welcomed. It was found that the latter of the two conclusions was the correct one. As a result, overhead was cut down, management was changed, and the business saved. This illustration serves to show what possibilities a bank has in helping customers to help themselves, thereby conserving the interest of both customer and bank.

ARTICLE VI

RÉSUMÉ

IN the previous articles we have tried to show that the handling of credits should include five elements, viz.:

1. General and specialized knowledge of trade conditions and prospects.
2. Thorough investigation.
3. The financial statement.
4. Analysis and deduction.
5. Revision and records.

In going over information before passing judgment on a risk, the data may appear to the mind as bearing no semblance to order, fact, hearsay and inference seemingly jumbled against an effort to obtain clear insight. If the mind is not naturally gifted in sifting information, and discarding that which is unnecessary, it must so educate itself from experience.

Brevity is something else than the soul of wit. It is the heart of business common sense. Some mercantile agencies could save

both themselves and their clients' time by making their reports brief and to the point. How much of the credit man's time is wasted in wading through a mass of verbiage. Verbosity is one of the unfortunate conditions that confronts us. A writer with a reputation gets paid for how much he says, not what he says. The English language is so commercialized that space and not merit often is the thing that counts. Condensation in the expression of thought should be practised as an attribute essential in modern business procedure. Its study should be included in the curriculum of all schools and business colleges. Of late, certain concerns have started to avoid the use of unnecessary courtesies in business correspondence. Service, not words, is after all, the best test of appreciation and merit. The business man wants a short cut to results.

"The study of mankind is man." The study of credits is largely the study of the genus homo—his mental, moral and physical make-up. Physiognomy is the science of discerning the character of the mind from the features of the countenance and the outward appearance. To be a good credit man, then, one should be a good physiognomist.

Wisdom comes with age; it may accompany youth, but youth is rampant with optimism. Too much optimism has been the pitfall of many credit risks. On the other hand, age, with all its wisdom, may become too pessimistic, and this means too much conservatism. How to preserve the happy medium—the balance that is finely adjusted to a fair point of view—is the problem that each credit man must solve for himself.

So, after all the information possible has been collected, and everything for the proper judgment of a risk has been done, the result depends, as stated in a former article, upon the timely use of the word "No."

Collateral credit has been considered as hardly relevant to the study of credits as discussed in this series. Yet, in view of the possibility of inflation and over-speculation in this country, caused by the European war, a brief discussion of the subject of collateral may be in order.

In accepting collateral for loans, the questions of title, security and market should be satisfactorily answered. It is important in every loan made to be fully satisfied as to the standing of the applicant for the loan. If an obscure applicant for collateral credit wants

a large loan, it would be in order first to determine that his position and standing are in character, even though the collateral furnished is ample. There is always a possibility of certificates of stocks and bonds being stolen or the amounts or the certificates raised.

Ample collateral means a liberal margin on good securities. Stocks of inflated land companies, bogus mines and other get rich quick promotions should be strictly tabooed. If investors insist on putting their money in enterprises of this kind, they should not be encouraged to do so by receiving loans on such security. It were better to make an out and out loan on open credit, provided the borrower is entitled to it. Just now unprecedented conditions are establishing records on certain classes of stocks and bonds. In times of feverish speculation for a rise, certain stocks bound up regardless of intrinsic merit. It is, therefore, more than ever important that stock exchange collateral on loans should be kept well mixed, in order that a fair proportion of standard securities may tend to stabilize the value of the collateral.

It is easy enough to determine whether the security is readily salable, if it is listed on an exchange, but there are many good stocks

and bonds which would find a ready local market that are never heard of on the regular market. Especially is this true of the South. Care should be observed, however, in making loans on stock of a company in which the borrower is heavily interested. We recall a case in which the head of a large concern was hypothecating his stock in that concern with various country institutions for small loans. These loans were made with banks to which the borrower was a stranger. It was so out of character with the prominence of the man, and the concern of which he was president, that suspicion was immediately cast upon the credit of the concern itself, and the bad failure of the same company a short time afterward justified those suspicions. If the borrower had gone to his own bank with legitimate reasons for the loans, there would probably have been no occasion for suspicion.

Only recently a national bank that occupied a high position on the roll of honor list was closed by the Comptroller. The bank got into deep water because a large part of its loans was tied up in the securities of companies in which the president of the bank was heavily interested. These securities went begging; the collateral, therefore, could not